MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 5 AND 6 SEPTEMBER 2012

1 Before turning to its immediate policy decision, the Committee discussed financial market developments; the international economy; money, credit, demand and output; and supply, costs and prices.

Financial markets

2 Trading volumes in financial markets had been unusually light during August, even allowing for seasonal variations. Market participants had remained focused on the prospects for changes in policy in the major economies, particularly in the euro area. Some clarification was expected from the ECB at its September policy meeting on what steps it would take to reduce the perceived risk of currency redenomination incorporated into the yields on the sovereign debt of some euro-area member states. In anticipation of this announcement, Spanish and Italian government bond yields had fallen, particularly for bonds with short residual maturities, but yields on longer-term bonds had risen in the second half of the month and, at the time of the meeting, the yield on Spanish ten-year government bonds was over 6½%.

3 In the United States, interest rates had fallen across the yield curve towards the end of the month in response to heightened expectations of a possible further loosening in monetary policy. In the United Kingdom, the majority of respondents to the Reuters survey of economists were anticipating a further expansion of the Committee's asset purchase programme at some stage, though this was not generally expected to be announced at the September meeting. Sterling had appreciated a little further on the month and was close to the top of the range it had traded in since the beginning of 2009.

4 Sterling Libor rates had fallen further relative to rates derived from overnight index swaps, continuing a trend that had begun following the announcements of the Funding for Lending Scheme (FLS) and of the activation of the Extended Collateral Term Repo facility (ECTR). That would put further downward pressure on lending rates for businesses with floating-rate loans linked to Libor. It remained too early to assess with any confidence the full scale of the effect the FLS would have on

borrowing by the household and corporate sectors, but there had been encouraging signs about the impact the Scheme was having on lending rates. Two of the largest lenders to the UK corporate sector had already announced improvements in the terms on some of their lending and there had also been some further announcements of reductions in interest rates on certain mortgage products, although some other banks had announced increases. It would probably take some time for banks to review fully their lending plans, however, and it was likely that drawings from the FLS would be spread out over the full window to end-2013.

5 Demand for corporate bonds had been robust and issuance by UK non-financial companies had been strong considering the usual lull in activity during August. Equity prices had risen on the month, by around 2% in the United Kingdom and United States, and by more than 6% in the euro area.

The international economy

6 The weak tone of data releases on the international economy had continued, and forecasts for growth in the major economies in 2012 and 2013 had generally been revised down. This weakness was more marked in indicators of manufacturing and trade, possibly reflecting a slowing in demand for capital goods against a backdrop of heightened global uncertainty, or a reduction in inventory demand.

7 Activity in the euro area had continued to be subdued. GDP had declined by 0.2% in the second quarter. Indicators for the third quarter had remained consistent with contraction, and the composite purchasing managers' index (PMI) had fallen a little further. Indicators of German output had also suggested some loss of momentum, following GDP growth of 0.3% in the second quarter.

8 It was likely that activity in many euro-area countries was continuing to be held back by difficulties in financing public and external deficits. During the month, several regional administrations in Spain had applied to the central government's Regional Liquidity Fund, and support had been announced for individual banks in both Spain and France. Further policy measures at an area-wide level were expected during the coming months. Alongside possible steps by the ECB to reduce strains in some sovereign debt markets, European leaders were due to discuss proposals to introduce a single euro-area bank supervisor and to continue the process of ratifying the European Stability Mechanism. The European authorities and the IMF were also due to complete their review of

the Greek programme during the autumn ahead of a decision on whether Greece would be eligible to receive the next tranche of funds.

9 The news from the United States had on balance been positive but did not suggest any material strengthening in output growth in the third quarter. Consumption had increased by 0.4% in July, following a decline of 0.1% in June, and non-farm payrolls had risen by over 160,000, a larger increase than recorded on average in recent months. There nonetheless remained uncertainty about how political negotiations over the extent of budgetary tightening in 2013 would be resolved and this, alongside developments in the euro area, was likely to weigh on sentiment and demand in the second half of the year.

10 Indicators for the larger emerging economies had generally continued to be consistent with activity growth below trend. Manufacturing PMIs had fallen further in Russia, India and China in August. Some of these declines were likely to be linked to the impact of previous domestic measures to combat inflationary pressures. But external demand had also slowed over the past year, in part reflecting lower import growth in the euro area. Monetary policy had since been loosened in a number of countries, and the governments of both China and Brazil had announced plans to increase spending on infrastructure. Policymakers generally appeared to have scope to provide more stimulus if that were deemed appropriate. But it was likely that growth in the major emerging economies would for some time remain weaker than pre-crisis averages.

11 Oil prices had risen by 8% on the month. Although month-to-month changes of this magnitude were not that unusual, this was during a period of relatively weak global activity growth, suggesting it had been caused by supply-side developments. Global oil production had continued to be hampered by supply disruptions, and it was likely that investors were prepared to pay a premium to hold physical oil given the recent heightened tensions in the Middle East. The production of industrial metals had suffered fewer supply problems and prices had generally risen by less. The prices of some agricultural commodities had remained elevated reflecting droughts in both the United States and parts of Eastern Europe, but they had not changed much on the month.

Money, credit, demand and output

12 The ONS had revised up its estimate of the change in UK GDP in the second quarter by 0.2 percentage points to -0.5%. The revision had largely resulted from smaller estimated contractions in output in the construction and manufacturing sectors. That would be consistent with the impact on activity of the additional bank holiday for the Diamond Jubilee having been a little less than the Committee had previously assumed or underlying growth having been a little stronger. The breakdown of GDP into its expenditure components suggested that final demand had been particularly weak, with both investment and net trade subtracting materially from growth, and the only positive contribution had come from stockbuilding. But these initial expenditure estimates were prone to revision.

13 Measured GDP could be expected to rise sharply in the third quarter as the Diamond Jubilee effect unwound, alongside a possible small boost from the Olympics. In line with the usual pre-release arrangements, the Governor informed the Committee that industrial production had risen by 2.9% in July, with robust increases in both manufacturing and energy and extraction output. The Markit/CIPS indices for August had also risen, with increases in activity recorded in both the manufacturing and service sectors. If the activity indices were to remain at their August levels until the end of the year, that would be consistent with a modest rate of underlying growth in the fourth quarter. The expectations and new orders indices, however, which usually gave a better prediction of activity trends at that horizon, had been weaker and did not yet suggest a return to growth.

14 Any sustained recovery in output would probably need to be accompanied by a pickup in consumption. The fall in inflation over the previous year and the surprisingly strong rate of employment growth more recently had together alleviated some of the squeeze on real incomes. There were some signs that this was beginning to lead to increased spending by households. Retail sales volumes in the three months to July had been 1.4% stronger than in the previous three months, the fastest rate of growth since the three months to April 2008. Private car registrations had also risen firmly over the same period. But other factors cautioned against expecting a lasting upswing at this stage. Uncertainty remained elevated and this would continue to discourage spending. The prospective rises in prices for petrol, household energy and some foodstuffs would dampen real income growth in the second half of the year, and the level of activity in the housing market had remained moribund. The effect these factors would have on consumption would depend in part on the impetus given to lending by the introduction of the FLS and the impact of the expansion of the

Committee's asset purchase programme. In this regard it was encouraging that household broad money growth had picked up during the first half of the year to its fastest twelve-month rate since the beginning of 2009.

15 The outlook for spending in the rest of the economy was generally weaker. Goods export volumes had fallen by over 7% in June, concentrated in exports to other EU countries. Forward looking indicators had been mixed, with the CBI survey of manufacturing recording a drop in export orders in August, but with the Markit/CIPS export orders indices recovering sharply from their fall in July. Surveys of investment intentions had fallen back more consistently and many of the contacts of the Bank's Agents had downgraded their capital spending plans in light of weakening demand.

Supply, costs and prices

16 Twelve-month CPI inflation had picked up to 2.6% in July from 2.4% in June. The increase had reflected a rise in the airfares component, which tended to be volatile, and an increase in the contribution of clothing and footwear price inflation following some earlier than normal summer sales.

17 In line with the usual pre-release arrangements, the Governor informed the Committee that producer input prices had risen by 2% between July and August, while output prices had risen by 0.5%, both reflecting the recent rises in oil prices. These rises, together with the prospect of further increases in utility prices not directly related to wholesale energy costs, meant that CPI inflation was less likely to fall back further during the second half of the year than the Committee had thought at the time of the August *Inflation Report*. The increase in the prices of agricultural commodities earlier in the summer, other things equal, would also begin to be passed through to consumer prices over the course of the coming year, although other import price pressures had generally remained subdued.

18 The labour market had remained surprisingly resilient in the face of the contraction in activity. The unemployment rate had fallen to 8% in the second quarter, its lowest level for around a year, and employment was estimated to have risen by more than 200,000, with a rise in permanent employees accounting for more than half the increase. It remained difficult to reconcile this with the persistent weakness in output. Contacts of the Bank's Agents had suggested that depressed trading conditions meant employees in some sectors had to work harder to generate new business. Some companies were likely to have needed to retain a certain minimum level of staff to continue operating, while the difficulty in recruiting labour with specialist skills may have led others to hold on to some employees

currently underemployed. Alternatively, an environment of heightened uncertainty might have led companies to choose to rely more on increasing staffing as a means of expanding capacity, rather than investing in plant and machinery which took a long time to come on stream and was more costly to reverse if demand turned out to be insufficient. Some of the factors contributing to the weakness in productivity might have persistent effects, for example possible impairment to the efficient allocation of capital stemming from problems in the financial system. It was unlikely that any one factor alone could satisfactorily explain all of the conjunction of weak output growth and relatively strong employment growth.

19 Wage pressures had remained muted. Private sector regular pay in the second quarter had grown by 2% relative to a year earlier, reflecting subdued settlements. But the continuing weakness in output growth and strength in employment growth meant that productivity in the second quarter had disappointed once again, even allowing for the impact of the extra bank holiday. As a result, notwithstanding the modest rate of wage inflation, growth in unit wage costs had risen. If productivity growth were to remain weak, wage increases would be held back, but it was also possible that inflation might fall more slowly than the Committee had previously expected.

The immediate policy decision

20 The Committee set monetary policy in order to meet the 2% inflation target in the medium term. Inflation was now much closer to target than nine months ago, having fallen from a peak of 5.2% in September 2011. As inflation had fallen back, the near-term outlook had at various points been jolted by sharp movements in both directions in the prices of commodities; it was not sensible in such an environment to ascribe a high probability to any particular short-run projection. That remained the case this month. Nonetheless, the rise in oil prices and the probable increase in utility and some food prices meant that the near-term outlook was for a less rapid fall in inflation than the Committee had thought at the time of its August *Inflation Report* projections. The outlook for inflation beyond that point continued to depend on the strength of the headwinds confronting both demand and supply, and the effectiveness of policy measures in the United Kingdom and abroad in leaning against them.

21 Measured output had continued to be affected by transient factors, obscuring the underlying path, and GDP growth in the third quarter would be boosted by the unwinding of the Diamond Jubilee effect. The Committee's August *Inflation Report* projections had been consistent with a modest recovery in underlying activity beginning towards the end of the year and into next year, although the

precise timing was uncertain. The robust July Index of Production numbers would require further study but, alongside the monthly indicators of consumption and the surveys of output in August, they suggested some modest underlying expansion. Set against that, however, the more forward-looking components of the business surveys were weaker, and the rise in energy prices would mean that the squeeze on real household incomes would not ease further in the short term.

22 The slowdown in the global economy, particularly in the euro area, was probably a factor behind the relatively weak expectations for activity reported by the UK business surveys. Further steps were likely over coming weeks and months to alleviate strains in the euro area and to provide additional support for vulnerable member states as they sought to finance public and external deficits and to rebalance their economies. Nonetheless very substantial risks were likely to remain for some time to come, which, if they crystallised, could have a considerable impact on the stability of the global banking system. Even if a disorderly outcome were avoided, it was probable that the threat of such an event would continue to weigh on domestic economic activity for some time. The risk of a sharper slowdown in emerging economies could also not be discounted, although monetary policy had been loosened in a number of countries and further stimulus was possible. The larger Asian economies and banks were more important to the global trade and financial system than at the time of the Asian crisis of the late 1990s, so the potential spillovers from a significant slowdown could be greater, although these would probably also be mitigated by accompanying falls in commodity prices.

23 The extent of a prospective pickup in domestic activity would also depend on how much the FLS boosted lending to households and firms in an environment in which some banks could otherwise be seeking to reduce their lending, perhaps materially. The Committee noted that banks would need time to review fully their lending plans and products, and it was likely to be some while before there would be drawdowns on a significant scale. Lending rates were thus a more immediate guide to the Scheme’s impact and it was encouraging that there had been further cuts announced by some banks on some of their lending products.

24 Turning to inflation, the Committee continued to judge that there was a substantial margin of spare capacity in the economy, particularly in the labour market. This would continue to bear down on domestic inflationary pressures for some time. But oil prices had risen again and continuing tensions in the Middle East meant they could possibly increase further. The further strong growth in employment in the second quarter had been very welcome but, set against the continuing weakness in output growth, it implied another fall in measured productivity. Even though the rate of growth of

nominal wages remained subdued by historical standards, this continuing fall in productivity meant that firms' labour costs were now rising more rapidly. If this continued, businesses were likely at some point to seek to reduce wage growth or staffing levels. But, in the meantime, there was a risk that labour cost growth, and so CPI inflation, would fall more slowly than the Committee had previously anticipated.

25 The Committee discussed whether it was appropriate to modify or continue with the programme of asset purchases it had agreed at its July meeting. Although there would probably be further volatility in measured output growth over the rest of the year, the level of demand remained weak and the outlook was subdued and uncertain. Inflation was considerably lower than a year ago, but it was still above target and likely to fall back more slowly during the remainder of 2012 than previously anticipated. The FLS was still in its early stages: it had the potential to reduce funding costs and to encourage the supply of credit. Set against that, heightened uncertainty, stemming especially from the euro area, and risk aversion on the part of households and businesses might limit the demand for credit, making the impact of the FLS difficult to predict.

26 Overall there had been little news regarding the medium-term outlook for inflation. Against that backdrop, all members agreed that it was appropriate at this meeting to continue with the asset purchase programme announced at the Committee's July meeting. For most members this decision was relatively straightforward, although some of these members felt that additional stimulus was more likely than not to be needed in due course, while others saw the risks to inflation in the medium term as being more balanced around the target. Over the next few months, the Committee would gain further insight into the underlying paths of both supply and demand. It could also take stock of the impact of past and prospective policy actions, here and abroad. For one member, the decision this month was more finely balanced, since it was not clear that the uncertainties about the medium-term outlook would be resolved to any great extent in the coming months and, given the weakness in demand, a good case could be made at this meeting for announcing more asset purchases.

27 The Governor invited the Committee to vote on the propositions that:

> Bank Rate should be maintained at 0.5%;
>
> The Bank of England should continue with the programme of asset purchases totalling £375 billion financed by the issuance of central bank reserves.

Regarding Bank Rate, the Committee voted unanimously in favour of the proposition.

Regarding the stock of asset purchases, the Committee voted unanimously in favour of the proposition.

28 Since the Committee's previous meeting, it had been consulted over the size and terms of the Bank's ECTR facility, in advance of the monthly auction on 15 August.

29 The following members of the Committee were present:

Mervyn King, Governor
Charles Bean, Deputy Governor responsible for monetary policy
Paul Tucker, Deputy Governor responsible for financial stability
Ben Broadbent
Spencer Dale
Paul Fisher
Ian McCafferty
David Miles
Martin Weale

Dave Ramsden was present as the Treasury representative.